RESEARCH SPOTLIGHT

Q1 2023 The Politics of ESG

As professional investors, we understand investing as a discipline to be fundamentally separate to the political sphere; while political actions in the public realm can of course influence investment outcomes (e.g. the Inflation Reduction Act in the US, or the EU "Green Deal" policy initiatives, for example), professional investors focus on adapting and responding to the political landscape, rather than engineering a political agenda. However, the increasing polarisation of political ideologies seen in the US across a plethora of issues has become more and more pronounced over the last several years, and unfortunately it is now impossible to ignore that "ESG", in the broadest sense, has now become part of the political landscape.

This has taken a fresh turn in the last several months, as we have seen an increased attempt to politicise ESG at the corporate level and the investor level by Republican politicians, under the guise of an attack on what is being called "woke-ism" by leaders such as Florida Governor Ron DeSantis.[1] According to Wikipedia, the term "woke" is an adjective meaning "alert to racial prejudice and discrimination", and has typically been viewed as an expression of sensitivity to systemic injustices and prejudices.[2] However, more recently "woke-ism" is being redefined by the right wing as the promotion of a progressive liberal ideology and "political correctness", with a heavy negative connotation. However one may want to interpret the language, we feel it is critical to distinguish between the political rhetoric of the big tent of "anti-ESG" advocates, and the value of ESG integration in investment decision making – something we view as apolitical, and altogether sensible.

In this spotlight, we review some of the recent political attacks on "ESG", the potential implications, and review the rationale for our approach to ESG investment – a process that's about data, risk/reward, and trying to make better investment decisions, rather than politics.

The "War on Woke" and anti-ESG Politics in the US

Traditionally, conservative policy has held that the government should avoid interference in private business decisions. It now appears this policy view has shifted; for months now, conservative advocacy groups backed by right-wing donors have mounted a campaign in "red states" to stop what they term "woke" investments that take into account climate risks and/or social issues.

Some Republicans have begun promoting the idea that ESG investing is a manifestation of so-called "woke culture" and represents investing at the expense of financial performance and fiduciary duty, the legal obligation that requires investment managers and trustees to act in the best interests of their clients or beneficiaries.[3],[4]

Florida Governor Ron DeSantis has already made his own fight against "woke" businesses a hallmark of his image. He recently announced legislative initiatives targeting financial companies that utilise ESG criteria in investing.[5] These bills would ban banks and other financial groups from "discriminating against" energy companies, gun sellers and other businesses. Asset managers would also be banned from considering ESG in investment decisions. "We are going to make sure that ESG is not infecting other decisions at both the state and local governments," DeSantis said.[6]

Unsurprisingly, this recent surge in anti-ESG rhetoric, political messaging and legislative initiatives is not coincidental, and it appears the driving force behind this anti-ESG movement are well known conservative policy institutes or "think tanks", such as The Heritage Foundation, American Legislative Exchange Council (ALEC) and The Heartland Institute. Some of them are linked to fossil fuel industry funding and climate change denial; most of their donors are not required to be disclosed.[7]

Members of these groups have helped to draft "model legislation" that Republican lawmakers have replicated and are promoting now in state capitals. One bill would blacklist banks that refuse to invest in key state industries, like coal in West Virginia. In many cases, oil and gas companies have testified in support of the bills.[8] At least 49 anti-ESG bills have been introduced across the country already this year, according to a February report from law firm Ropes & Gray, while about 22 were introduced in 2022.[9]

1. https://www.flgov.com/2023/02/13/governor-ron-desantis-announces-legislation-to-protect-floridians-from-the-woke-esg-financial-scam/
2. https://en.wikipedia.org/wiki/Woke
3. https://www.reuters.com/legal/government/republicans-swim-against-tide-esg-money-2023-03-02/
4. https://archive.is/20230303033144/https://www.nytimes.com/2023/02/28/climate/esg-climate-backlash.html
5. https://www.esgtoday.com/desantis-outlaws-esg-in-florida-investments-procurement/
6. https://www.ft.com/content/7d305752-e2ee-420d-8883-6a9a246110f7
7. https://www.wbur.org/hereandnow/2023/03/22/esg-investing-fossil-fuels
8. https://www.wbur.org/hereandnow/2023/03/22/esg-investing-fossil-fuels
9. https://www.ft.com/content/7d305752-e2ee-420d-8883-6a9a246110f7

All of this anti-ESG political effort stands in stark contrast to the EU's stance, which has strongly advocated the value of ESG investing and seeks to direct capital towards sustainable investments. In the EU, ESG considerations have been viewed as congruent with financial performance, have been heavily incorporated into financial regulations, and have become integral in many investment strategies. The EU has taken several steps to actively promote ESG investing, including the adoption of the Sustainable Finance Action Plan in 2018, which aims to mobilize private capital towards sustainable investments. The plan includes a range of measures, such as developing a taxonomy for sustainable activities, establishing a green bond standard, and requiring asset managers to disclose how they integrate sustainability into their investment decisions. In addition, the EU has also introduced regulations such as the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy Regulation, which require financial market participants to disclose information on the sustainability of their investments and to use a common classification system for sustainable economic activities.[10],[11],[12]

The backlash to the backlash

Every action demands a reaction in politics, and it is not a surprise that there has been significant opposition to the recent anti-ESG movement in the US, and not only from Democrats. At the Federal level, in February the Senate passed a measure to overturn a Labor Department rule allowing money managers to consider ESG criteria in pension investment decisions.[13],[14] On March 20th President Biden vetoed the bill, marking the first veto of his administration.[15]

At the state level, the political rejection of ESG is being challenged. In Republican strongholds such as North Dakota, Indiana, Mississippi and Kentucky, legislators have voted down proposals to prevent state governments or pension funds from doing business with firms that have adopted ESG principles. In North Dakota, a pair of anti-ESG proposals were heavily defeated earlier this year.[16] One was legislation that would have required the state's banking association's treasurer to list financial companies accused of boycotting energy suppliers. The boycott bill was voted down in the state house.[17] The Indiana Bankers Association is also lobbying against legislation that would require the state divestment from financial groups that consider ESG factors. The same pattern is also being seen in Nebraska. In a somewhat ironic twist, anti-ESG legislation appears to be failing in large part due to violating conservative principles around free markets and exhibiting "government overreach".

In another example of challenges at the state level, the Kentucky County Employees Retirement System wrote a letter in response to Kentucky State Treasurer Allison Ball regarding her insistence that the pension fund divest from companies her office deemed as boycotting the energy sector. The Kentucky retirement system concluded that following Ball's divestment policy would "violate its own legal obligations".[18] Ed Owens III, CEO of the Kentucky Public Pensions Authority said, "We're simply informing the treasurer that we believe that to comply here would be inconsistent with our fiduciary duty."[19] The idea that ESG considerations are somehow opposed to, or in conflict with, fiduciary obligations is not going unchallenged.

ESG has become so politicised that Republicans supporting the legislation are "willing to take a loss", said Indiana state Rep. Ed Delaney, who opposed the state boycott bills. "These state legislators are playing politics with our pension plans" said Brandon Rees, deputy director of the AFL-CIO Office of Investment.[20]

Taking a stand: our ESG view

It won't come as a surprise to our readers that we are disheartened by the increasing politicisation of ESG, and feel that the characterisations of "ESG" broadly speaking, and ESG investing and integration specifically, as put forward by the recent anti-ESG movement are, for the most part, disingenuous and misleading – presenting a straw man argument at best, and outright misrepresentation of the investment process at worst.

We firmly believe that ESG investing represents a fulfilment of fiduciary duties towards shareholders and that the current anti-ESG movement is based largely on political ideology, rather than an honest assessment of investment materiality, stock performance, and business outcomes. Our focus is on ESG materiality in improving the investment process and we focus on performance and outcomes; we do not consider ourselves philanthropists or political actors.

1. https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en
2. https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en
3. https://www.lexology.com/library/detail.aspx?g=e69da89a-f166-4dd1-bb42-9fe8e6808c33
4. https://www.washingtonpost.com/business/2023/03/14/svb-esg-woke-investing/
5. https://www.reuters.com/business/us-senate-poised-consider-blocking-biden-esg-investment-rule-2023-03-01/
6. https://www.vox.com/politics/2023/3/20/23643243/joe-biden-veto-esg-republicans-woke-capitalism
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8. https://www.ft.com/content/7d305752-e2ee-420d-8883-6a9a246110f7
9. https://citywire.com/pro-buyer/news/kentucky-pension-plans-push-back-against-states-esg-blacklist/a2408934
10. https://www.pionline.com/esg/amid-esg-backlash-kentucky-pension-fund-says-it-will-not-divest-blackrock
11. https://www.institutionalinvestor.com/article/b8xrfm5mtrrhxh/The-Backlash-Against-ESG-Faces-Its-Own-Backlash

As we know, every investment thesis has its own challenges, ESG investing included. We do not shy away from discussing challenges and reasonable concerns about ESG in depth. For example, in our Q1 2022 newsletter we discussed concerns around ESG crowding in certain industries (please see our investor portal for the full discussion). However, we see the backlash against ESG in the US as a clear partisan politicisation of an investment strategy which has little connection to political ideology. In his letter to CEOs, BlackRock CEO Larry Fink, a critic of the anti-ESG movement, has said that "stakeholder capitalism is not about politics. It is not a social or ideological agenda."[21] We agree.

Why do we feel there is no conflict between ESG integration and a fiduciary responsibility to seek appropriate risk adjusted returns? Incorporating ESG considerations into investment decisions can help investment managers fulfil their fiduciary duty by mitigating risks and identifying opportunities that could impact the long-term financial performance of the investments they manage. By taking ESG factors into account, investment managers and trustees can identify companies that are well-managed and well-positioned for the future, while avoiding those that may be vulnerable to investment risks that might not be identified through a traditional income statement / balance sheet fundamental analysis approach.

ESG considerations identify the material long-term risks companies face from ESG-related issues. A Harvard Business Review article perfectly explains, "Climate change is one such risk for many companies — particularly those with shoreline assets that are vulnerable to rising seas, or those (such as fossil-fuel companies) for whom future revenue would be greatly reduced if governments start taxing carbon. As a result, greenhouse gas emissions are a material issue for an oil and gas exploration company, as are air quality and employee health and safety."[22]

"We're looking at ways in which climate, labor practices and human rights are going to affect the profits and losses," said Witold Henisz, the vice dean of the University of Pennsylvania's ESG initiative. "So the goal is just to do good investing." Tensie Whelan, the director of New York University's Stern Center for Sustainable Business, said "ESG should be thought of as a system of measurement, from purely assessing an investment's risk and opportunities, to trying to make an impact…Companies that don't embrace sustainability are going to end up like companies who didn't embrace digitalisation…If you're a coffee company or a property…insurance company and you're not managing for climate change, you're not going to be in business."[23]

BEYOND RISK: Evidence for ESG in Security Selection & Stock Performance

As we have noted in our Research Spotlights over the past four years, an increasingly deep pool of research in the last decade has found that ESG factors can have a positive impact on financial performance and value creation. In a recent update for 2022 ESG factor performance, MSCI analysis has found that higher ESG scores have been associated with lower stock-specific drawdown risk, as well as better earnings growth and stock performance[24]. An older meta-study published by Gunnar Friede, Timo Busch & Alexander Bassen analysed more than 2,000 studies on the relationship between ESG factors and financial performance and concluded that "roughly 90% of studies find a non-negative ESG–corporate financial performance relation. More importantly, the large majority of studies report positive findings".[25]

Despite the political pushback regarding the "S" in "ESG", we have found social considerations to be important alpha drivers in security selection. In our newsletters, one ESG theme that we have researched and discussed in the Spotlight is employee satisfaction. A large body of studies have found that employee satisfaction has a strong positive relationship to company performance. We have done an extensive literature review of these studies. Particularly insightful research has been published by Alex Edmans (2011, 2020)[26],[27], Welch and Yoon (2020)[28], Oswald, Proto and Sgroi (2015)[29], Green et al. (2019)[30], and Bellet et al. (2019)[31]. Our in-depth review of existing literature on employee satisfaction and stock performance can be found in our Q1 2021 newsletter available on the investor portal.

21. https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter
22. https://hbr.org/2023/02/rescuing-esg-from-the-culture-wars
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28. Welch, Kyle, and Aaron Yoon. "Corporate Sustainability and Stock Returns: Evidence from Employee Satisfaction." SSRN Electronic Journal, 2020, doi:10.2139/ssrn.3616486.
29. https://wrap.warwick.ac.uk/63228/7/WRAP_Oswald_681096.pdf
30. Green, T. Clifton, et al. "Crowdsourced Employer Reviews and Stock Returns." Journal of Financial Economics, vol. 134, no. 1, Oct. 2019.
31. Bellet, Clement, et al. "Does Employee Happiness Have an Impact on Productivity?" SSR

Signature Bank – an ESG Materiality Case Study

"Go WOKE, get broke!" or "ESG can help you see?"

Sometimes it seems that there's nothing that ESG cannot be blamed for by its most vocal critics. As the recent US regional banking crisis unfolded, anti-ESG agitators were quick to blame ESG. GOP Rep. Ronny Jackson of Texas blamed the "WOKE agenda" for the Silicon Valley Bank collapse, claiming the company wasted money on ESG policies and "CRT CRAP" (referring to Critical Race Theory). "How much money did they WASTE on financing ESG/CRT CRAP? The insane left-wing agenda is BANKRUPTING our future. Go woke, GET BROKE!" Jackson tweeted.[32]

We respectfully beg to differ with Rep. Jackson with respect to the value of ESG from our perspective as investors focused on stock selection; ESG criteria have helped our Fund avoid some of the recent turmoil in the financial sector, and indeed, helped to identify appropriate short book candidates on ESG grounds. Signature Bank, a short position in Q1 2023, provides an interesting case study.

Signature Bank was a 23 year old New York-based regional bank that had more recently focused on digital assets by becoming one of a few banks to accept cryptocurrency deposits.[33] The bank was shut down by federal regulators in March due to regulator concern about depositors withdrawing large amounts of money after the failure of Silicon Valley Bank and the fear of contagion.[34] Customers quickly withdrew their deposits, the New York Times reported, after shares fell by nearly 25%, to $70 after briefly being halted on Friday morning over fears of volatility[35]. The FDIC shut the bank on March 12th, wiping out the equity value in the process.

Did Signature Bank have any credentials as a so-called "woke" ESG leader in the banking sector? In our view, quite the opposite.

The Fund held Signature Bank in our short book based on our analysis and profile as a poor ESG company according to our ESG scoring methodology. As well as being penalised for excessive and poorly aligned compensation structures for senior executives, Signature Bank also lagged peers when evaluated on privacy and data security criteria, overall corporate governance, and business ethics and compliance issues. Though less impactful in our assessment, additionally, we also viewed Signature Bank as an "E" pillar laggard due to its lending practices to the fossil fuel industry.[36]

Was there good alignment between management and shareholders from a governance perspective? We note that senior management at the lender offloaded approximately $100m of its stock in the 3 years leading up to its collapse last month. About half of those sales were by Signature's chairman Scott Shay, the bank's former CEO, as well as his successor.[37],[38] These executives were all part of the board committee that oversaw the bank's risk profile. The excessive levels of insider selling were hardly indicative of a management team well aligned to long term shareholder value.

The case of Signature Bank is a clear example of how an ESG analysis can provide an advantage in investor decision-making by helping to identify better governed companies, that better manage risks, and – ultimately – can outperform over the cycle. And in the case of Signature Bank, to avoid (or short) companies that fail to meet acceptable ESG standards.

32. https://abcnews.go.com/Politics/republicans-blaming-bank-failures-woke-policies/story?id=97852517
33. https://www.forbes.com/sites/brianbushard/2023/03/13/what-happened-to-signature-bank-the-latest-bank-failure-marks-third-largest-in-history/?sh=1b1b4d9490ff
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